FUND DEMOCRACY

March 28, 2001

Jonathan G. Katz

Secretary

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, DC 20549-0609

Re: Petition for Rule-making

Dear Mr. Katz:

The Investment Company Institute[1] hereby petitions the Commission to adopt a definitional rule, as set forth in the attached Appendix, clarifying that certain portfolio investment programs form "investment companies" within the meaning of the Investment Company Act of 1940 (the "1940 Act"). The rule defines such an investment company as any group of persons who purchase a pre-selected portfolio of securities with characteristics demonstrating investment management by others. The rule would require that such companies be registered and regulated under the 1940 Act and that the offering and sale of their shares be registered under the Securities Act of 1933 (the "1933 Act").

The portfolio investment programs that are the subject of this petition represent a new wave of investment vehicles that, if not appropriately regulated, could seriously undermine the investor protections built into the regulatory framework for investment companies and their investment advisers.[2] Thus, we respectfully request that the Commission adopt the proposed rule in order to prevent abuses.

Summary

• The sponsors of the portfolio investment programs that are the subject of this petition are offering to public investors professional investment management of a common securities

portfolio — the touchstone of investment company regulation. Investors who purchase substantially the same pre-packaged portfolios, coupled with periodic portfolio updating features and a connected share trading service, are an organized group of persons engaged in a common investment enterprise, an enterprise that constitutes an investment company subject to the 1940 Act. Moreover, these investment programs pose the same risks to investors that underlie important parts of the investment company regulatory pattern — risks of self-dealing, overreaching in fees, deviating from stated investment policies, inadequate mechanisms for resolving conflicts of interest, and abuses in disclosure and advertising. Future sponsors of such investment programs may not have the same level of integrity as current sponsors, which exacerbates the potential for these abuses.

There are compelling arguments for the Commission to act quickly to assert jurisdiction over portfolio investment programs under both the 1933 and 1940 Acts. These investment companies, if permitted to evade investment company regulation, threaten to undermine the regulatory system for all investment companies. Although these programs may provide their investors the *option* to customize their pre-packaged portfolios, the most important test for investment company regulation — *reliance* on parallel professional investment management — still applies to them. If these investment companies are not subject to regulation appropriate for the potential abuses they pose, their investors will be deprived of crucial protections. In addition, they will provide an opportunity for ready evasion of the burdens of investment company regulation. If the Commission acts quickly while the product is in an early stage, it can prevent regulatory evasion rather than face the task of trying to re-regulate a substantial sub-industry with a strong vested interest in fighting investor protections.

Proposed Rule

Attached to this petition as an appendix is the text of a proposed definitional rule. The proposed rule is designed to extend the regulatory protections of the 1940 Act to public investors who are offered the opportunity to participate in a common enterprise through pre-packaged portfolios

and portfolio updating and trading features. It would treat all investors in such a program who purchase substantially the same portfolios coupled with portfolio updating services and a trading service for portfolio securities as an organized group of persons engaged in a common enterprise that constitutes an investment company subject to the 1940 Act. The requirements of the 1940 Act, however, might need to be altered through narrowly tailored exemptions for these investment companies to operate.

The rule is intended to clarify the scope of the definition of "investment company" under the 1940 Act and is not intended as an exclusive definition. Thus, an investment program that did not meet all of the conditions of the rule might still, under some circumstances, qualify under the 1940 Act as an investment company.

Background

What are portfolio investment programs?

Portfolio investment programs allow investors to purchase in a single transaction pre-packaged portfolios of stocks through a brokerage or advisory account. The pre-packaged portfolios consist of a number of stock positions, selected and weighted through professional management techniques. Investors purchase dollar amounts of a portfolio, not a given number of shares of individual stocks.[3] Investors choose from a number of pre-packaged portfolios created by the companies' sponsors. Investors can customize the pre-packaged portfolios by substituting stocks or adjusting weightings. Many investors will likely choose pre-packaged portfolios because of their convenience and because of the complexity and difficulty of devising and managing one's own portfolio. The sponsors of portfolio investment programs are promoting a large number of pre-packaged portfolios, and their contents and types appear to vary considerably. Nonetheless, the names and investment objectives of the portfolios mirror those of traditional investment companies.[4] The sponsors of portfolio investment programs periodically update their pre-packaged portfolios: like professional investment managers, they regularly review their

manage many of its "synthetic funds" in much the same way that traditional mutual funds are managed.[9]

Significantly, the sponsors of portfolio investment programs do not provide investors with the means to evaluate meaningfully whether the changes to a pre-packaged portfolio are appropriate for their personal portfolios. Nonetheless, their programs will make it nearly effortless to adopt these changes for one's portfolio. They thus invite investors to rely upon the sponsors' expertise to manage their portfolios. There is little reason to doubt that a substantial number of investors will accept that invitation and depend upon the sponsors to provide an ongoing program of professional investment management. The securities held by those investors will in economic substance constitute a pool of capital managed by the sponsor, irrespective of the legal form of their holdings.

Investors must rely upon sponsor-provided or -arranged trading services to realize the round lot values of odd lot and fractional share holdings.

An investor in a portfolio investment program generally holds a portfolio of odd lots and fractional shares.[10] Because fractional shares are unmarketable[11] and odd lots can only be bought and sold with significant transaction costs, portfolio investment programs must offer their investors a trading service for these shares either directly or indirectly through arrangements with third-party brokers. Such a service permits investors, when purchasing, selling, updating, exchanging, customizing or rebalancing their portfolios, to buy and sell odd lots and fractional shares at close to round lot prices.

The trading service enables portfolio investment programs to offer portfolios to small investors and to value the odd lots and fractional shares making up each portfolio as if they were round lots of securities. Through such a service, the program may first try to match its investors' transactions internally or it may bunch the trades (including those that are unmatched) and take these to the market, or it may do both. The provider of the service also must commit its own capital to round up trades and maintain inventory. For such a service to function economically, a

the 30 stocks [in the S&P 500] that had betas closest to 0.6, and market capitalization and price-to-book ratios closest to the S&P 500 average." FOLIOfn is telling investors that it will examine the appropriate financial statements, acquire other necessary data, and perform the necessary statistical operations (e.g., linear regression) to select less risky stocks. Most non-institutional investors will not have the skills to perform these tasks themselves and thus will rely on FOLIOfn's expertise.

The web page continues: "The Folio is reviewed every month. If the characteristics of the Folio have changed substantially, the stocks included may change." Thus, FOLIOfn is telling investors that its managers will use their expertise to evaluate the portfolio periodically to determine if it meets its stated objective, and that they will change the portfolio if they judge that changing investment conditions warrant it. In fact, within a three-month period, FOLIOfn replaced twenty-five of the thirty stocks in the portfolio and changed the weightings for the other five without giving any reason for the changes. Many investors who have purchased the Conservative Folio before it was reconfigured, upon seeing these changes, will conclude that their current portfolios no longer meet their investment objectives and will want to update their portfolios.

Consider another pre-packaged portfolio, The Investec Energy Fund, to be made available on MAXFunds' website. The website states that it "is a 10 stock portfolio of large- or mid-cap stocks ... that represents a mix of top-down thematic sector bets ... and bottom-up individual stock picks." The site identifies the manager of the Fund, who explains his investment strategies: "I place a high importance on analyzing the supply and demand factors moving the oil price, as this provides the key context for forecasting individual company earnings. I then apply traditional valuation yardsticks and adopt a value style." The website also touts his experience at running three public funds. Thus, MAXFunds is promoting the manager's expertise, and many investors who do not have the sophistication in finance or in the energy business needed to analyze his techniques will nonetheless likely be persuaded to rely upon his investment management skills.[8] MAXFunds' chief executive officer has stated that investment advisers will actively

bans on self-dealing, limits on fees and sales charges, discipline on investment management, full disclosure, and standards for advertising, are unparalleled in the financial services world. The investment company industry has embraced this regulation and has flourished. The industry's commitment to integrity, shareholder interests, full and fair disclosure under the 1933 Act and substantive regulation under the 1940 Act has prevented abuses, reinforced a culture of integrity, and maintained high investor confidence in the industry for sixty years.

There are compelling arguments for the Commission to assert jurisdiction over portfolio investment programs under both the 1933 and 1940 Acts, as set forth below. As more sponsors begin to offer portfolio investment programs, there will be no assurance that they will operate as prudently as current sponsors do. In addition, portfolio investment programs, if permitted to evade this regulation, threaten to undermine the protections of this successful regulatory system.[13] Although the use of new technologies may provide their investors the *option* to customize their pre-packaged portfolios, the most important test for investment company regulation — *reliance* on parallel professional investment management — still applies to them. If these investment companies are not subject to regulation appropriate for the potential abuses they pose, their investors will be deprived of crucial protections. In addition, they could allow ready evasion of the burdens of investment company regulation. If the Commission acts quickly while the product is in an early stage, it can prevent regulatory evasion rather than face the task of trying to re-regulate a substantial sub-industry with a strong vested interest in fighting investor protections.

Discussion

Portfolio investment programs should be regulated under the 1933 and 1940 Acts.

An investment vehicle is an investment company under Section 3(a)(1) of the 1940 Act if it is an issuer of securities that is engaged, or proposes to engage, primarily in the business of investing, reinvesting, or trading in securities. The application of this test to portfolio investment programs turns on whether they are offering securities separate from the underlying securities

that constitute the investors' portfolios.

A. Portfoli inv stment programs offer and sell separate securities that should be registered under the 1933 Act.

Portfolio investment programs, by offering pre-packaged portfolios coupled with portfolio updating features, provide professional investment management upon which investors rely. Investors also rely on the trading services provided directly or indirectly by program sponsors so that investors' holdings of odd lots and fractional shares can be purchased and sold at prices close to the current market price for whole lots. For these reasons, portfolio investment programs bring together a promoter and investors in a common enterprise — the hallmark of an investment contract.

1. Portfolio investment programs are offering investment contracts, which are securities as a matter of law.

Section 2(a)(1) of the 1933 Act defines the term "security" to include investment contracts. The Supreme Court in the seminal *Howey* opinion defined the term "investment contract" to mean any "contract, transaction, or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party . . . ."[14] Portfolio investment programs clearly meet the first and third elements of this test. As set forth below, they also meet the second and fourth elements.

Generally, all courts agree that the common enterprise prong of the *Howey* test is satisfied when there is a pooling of interests of several investors, a pooling known as "horizontal commonality." Courts disagree, however, on whether "vertical commonality" — one promoter and one investor involved in a common enterprise — alone suffices. The Ninth Circuit has articulated a standard for vertical commonality under which a common enterprise exists where "the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."[15] The Commission has endorsed this approach.[16]

portfolio investment program must develop a critical mass of thousands of investors or more.[12]

When an investor seeks to dispose of his or her portfolio, the trades necessary to do so can only be executed economically through the trading service provided directly or indirectly by the sponsor. Similarly, an investor who relies on the periodic updates made to the pre-packaged portfolios also will have to rely on the sponsor's willingness and ability to continue providing the trading service. Investors will thus depend upon their relationship with that sponsor and will be subject to any fee increases that it might impose.

Sponsors promote portfolio investment programs as offering the advantages of mutual funds without the disadvantages.

FOLIOfn's website announces that it offers "the diversification of mutual funds and the benefits of owning the stocks yourself." It states that its portfolios give investors "the benefits of mutual funds without the hidden fees, adverse tax consequences, and lack of control." MAXFunds' site states that a "synthetic fund is similar to a mutual fund in that both are portfolios of securities you can buy. The main difference between the two is that with synthetic funds, you own the securities in the portfolio directly, not through a third party mutual fund company. Another difference is that the manager of the fund could be an investment advisor, like with a mutual fund, but can also be the publisher of a stock index, a financial writer, or even you." Netfolio's site states that it "offers custom-designed stock portfolios or 'Personal Funds' to individuals at a fraction of the cost of a typical mutual fund." It cites among the benefits of subscribing to Netfolio's investment service that "you can earn more" than by investing in mutual funds. None of these sponsors' sites points out that holders of their portfolios do not receive the regulatory protections that safeguard mutual fund investors.

P rtfolio investment programs do n t pr vide time-tested investor protections.

As a result of the 1933 and 1940 Acts, investment company shareholders benefit from a regulatory system whose core protections, which include oversight by independent directors,

packaged portfolios in a meaningful way. These investors will depend on the special expertise that the promoters of portfolio investment programs hold themselves out as offering. These investors will use pre-packaged portfolios rather than create portfolios themselves, will not customize their portfolios to any significant degree, and will rely upon the promoters' portfolio updating features to provide an ongoing program of investment management. Moreover, they will choose the ease and convenience of relying upon the continuing investment management program offered through updated pre-packaged portfolios. In the case of these investors, the undeniably significant and essential efforts will be those of the promoter.

The offerings of portfolio investment programs will form investment contracts even if some investors are not passive, but rather actively manage or customize their pre-packaged portfolios. As the *Howey* Court stated: "The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough that the respondents merely offer the essential ingredients of an investment contract."[22] (footnote deleted) When a promoter's offer leads some investors to expect profits through reliance upon the investment expertise of a promoter or a third party — as do the websites of portfolio investment programs — the *Howey* test has been met.[23] In analyzing the offer, one should look to the potential investors to whom the investment is being offered.[24] The sponsors of these programs promote their products as an improved alternative to mutual funds, which demonstrates the focus of their offer on investors most likely to view their interests in program portfolios as passive investments.[25]

The fact that investors in portfolio investment programs have the *option* to manage or customize their pre-packaged portfolios does not preclude a finding that many investors will rely upon the investment management of the companies' sponsors. A number of courts have recognized that, even where an investor has the right to control the management of his or her investment, the investor's practical dependence or an inability to exercise meaningful powers of control or to find others to manage the investment satisfies the *Howey* requirement of reliance upon the efforts of others. Accordingly, courts have found a wide range of investment vehicles in which investors

Portfolio investment programs satisfy both the horizontal and vertical commonality tests, however defined. First, these programs bring many investors into a common enterprise with the programs' sponsors and with each other through their reliance on the professional investment management provided by the sponsors. Investors who purchase pre-packaged portfolios and adopt the changes in those portfolios made by the sponsor rely on the sponsor's investment expertise — its prowess in devising and managing portfolios with the investment characteristics chosen by the investor. They depend upon the sponsors to provide an ongoing program of professional investment management. The investments of all of these investors in economic substance constitute a *de facto* pool of capital managed by the sponsor in a common enterprise. Second, portfolio investment programs' trading services for odd lots and fractional shares also bring their promoters and investors together into a common enterprise. Through these services, the investment success or failure of each portfolio is linked to the trading, marketing and technological success of the promoter. When the investor seeks to dispose of his or her portfolio, the necessary trades can only be executed at a feasible cost through the trading service provided directly or indirectly by the sponsor. As a practical matter, that service will be available only if the promoter continues to provide or arrange for it.[17] An investor who relies on adopting the sponsor's updates to a pre-packaged portfolio also must rely on the promoter's willingness and ability to continue providing that service. The fortunes of each investor therefore depend to a significant degree on the promoter's ability to attract and retain a critical mass of clients — that is, on the success of its sales and marketing efforts. If the promoter goes out of business or otherwise discontinues the trading service, investors will be left with holdings that will be so expensive to manage, rebalance, and liquidate that they will in effect lose significant value. Thus, the viability of each portfolio as an investment vehicle is "interwoven with and dependent upon the efforts and success of" the promoter.

The companies seek to match and/or bunch investors' purchase and sales orders to permit economical trades, through the trading service. This matching and bunching constitute

horizontal commonality because it pools the odd lot and fractional orders of many investors and puts their capital jointly at risk in the time between when the investor enters his or her order and the time the company executes the matched or bunched orders. The matching and bunching also constitute vertical commonality, because the investor's trading capital is brought into a common enterprise with the promoter's trading capital, which is required to round up odd lots and fractional shares in inventory and in market trades.

The fourth element of the *Howey* test requires that the investor be led to expect profits to be derived "solely from the efforts of a promoter or a third party." In applying the test, the federal courts have rejected a literal interpretation of the word "solely." Ten circuits have adopted a more liberal and flexible interpretation, simply requiring proof that "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[18] As a result, many courts have found that an investment constituted a security, even when the investor was required to participate to some extent, provided his efforts were not the undeniably significant ones.[19] As the Commission itself has noted, "an investment contract may be present in situations where an investor is not wholly inactive, but even participates to a limited degree in the operations of the [enterprise]."[20]

An investment vehicle meets this test if a significant number of investors in practice rely upon the efforts of the promoter either because the investors lack the necessary sophistication or because the promoter possesses some special skills or expertise. The investor is reliant upon the efforts of others "where the investor [shows] practical dependence, an inability to exercise meaningful powers of control or to find others to manage his investment" because he or she is inexperienced and unknowledgeable in business affairs or is dependent on some unique entrepreneurial or managerial ability of the promoter or manager.[21]

A significant number of investors in portfolio investment programs will not be experienced or knowledgeable enough in investment matters to manage or customize their investments in pre-

retain an option to manage their investments to be investment contracts — for example, discretionary commodities trading accounts,[26] condominium unit rental pools from which the investor retains the right to opt out,[27] dental products sales franchises coupled with an optional and terminable sales agency agreement,[28] and investments where investors' choices in purchasing portfolios of coins were made or guided by a coin dealer's experts.[29] In the *Hocking* case, the Ninth Circuit explicitly rejected the defendants' argument that "the purchaser's election to delegate control and ability to regain control [leads] to the conclusion that the ["reliance on the efforts of others"] requirement of *Howey* had not been satisfied."[30] The availability of a trading service for odd lots and fractional shares is also undeniably significant to the success of each pre-packaged portfolio. An investor who wants to update or sell his or her portfolio will have to rely on the promoter's willingness and ability to continue providing that service. In the *Gary Plastic* case, the Second Circuit found that, under facts similar in significant ways to those presented by the sponsors' trading services, investors' reliance upon the trading efforts of a broker-sponsor was also a significant factor in creating a security for purposes of the 1933 Act.[31] In *Gary Plastic*, Merrill Lynch had marketed and sold large denomination bank certificates of deposit (or "jumbo CDs") on representations that the CDs were negotiable and liquid. Merrill Lynch undertook to maintain a secondary market for the CDs that would enable investors to sell the CDs back to Merrill Lynch at prevailing market prices without penalties. The Second Circuit held that Merrill Lynch was offering and selling investment contracts because investors in the jumbo CDs relied for the sale of the CDs without penalty on the "efforts, knowledge and skill" as well as the "financial stability" of Merrill Lynch: the value of their investments depended on the secondary market that Merrill Lynch created for liquidity and on Merrill Lynch's marketing efforts, because the success of the secondary market hinged on Merrill Lynch's success in finding new buyers of CDs or in committing its own capital to make a market.

Portfolio investment programs bring investors and sponsors together in a common enterprise in

which a significant number of investors in pre-packaged portfolios rely upon the investment management, securities trading and sales efforts of the sponsors. Thus, these sponsors are offering and selling securities separate from those constituting the underlying portfolios.[32]

2. Portfolio investment programs warrant registration as securities under the 1933 Act as a matter of policy.

There are compelling policy reasons to require the distribution of interests in portfolio investment programs to be registered as separate securities under the 1933 Act. To make an informed decision, investors considering an investment in a pre-packaged portfolio need disclosures regarding the sponsor's investment management expertise, the investment objectives of the pre-packaged portfolio, and the underlying reasons for any changes to the portfolio. Investors also need disclosure of the risk factors involved in investing in a particular pre-packaged portfolio and those involved in relying upon a particular sponsor. Moreover, since the fortunes of investors to a significant extent are dependent upon the efforts of the sponsor and interwoven with its fortunes, investors need to be informed about its business, finances, and management. Such information is necessary to assess the risk investors would face if the sponsor were no longer available to provide professional investment management or a trading service for odd lots and fractional shares. Investors also need the protections of the 1933 Act provisions for prospectus delivery and regulating other forms of communication during offerings. Finally, investors need the assurances of accuracy and completeness provided by the prospect of Section 11 liability for material misstatements and omissions.

Compliance with the prospectus delivery requirements of the 1933 Act would not impose unreasonable burdens on portfolio investment programs. Indeed, these companies could maintain a current prospectus and readily deliver that prospectus to investors through posting the prospectus on their sponsors' websites in the same manner as do the sponsors of traditional mutual funds.[33]

B. Portfolio investment programs should be regulated under the 1940 Act.

1. Because portfolio investment programs have the characteristics of traditional investment companies, their investors should be protected by the 1940 Act.

Portfolio investment programs share most of the essential characteristics of investment companies. Like mutual fund investors, their investors will be relying upon an ongoing program of professional investment management. Like mutual funds, portfolio investment programs offer investors the ability to liquidate or redeem their interests at close to market prices for round lots of securities. Like mutual funds, they offer smaller investors the benefits of portfolio diversification. Like the interests of shareholders in investment company portfolios, investors' holdings will, in real economic terms, be indirect: without a trading service to update and liquidate their portfolios of odd lots and fractional shares, their holdings will be worth significantly less than market price.

Promoters may claim that they are offering these features as incidental to a brokerage or an advisory account. However, when the features are considered as a whole, these accounts constitute a group of persons organized through parallel investment management into a common enterprise — an investment company — rather than investments through a brokerage or advisory account. Investors' reliance on pre-packaged portfolios, portfolio updating, and a trading service for purchasing the pre-packaged portfolios and updating them creates a type of relationship with the companies' sponsors that differs dramatically from that traditionally found between brokers or advisers and their clients.

2. Portfolio investment programs meet the definition of "investment company" under the 1940 Act.

An investment vehicle is an investment company under Section 3(a)(1) of the 1940 Act if it is an issuer of securities that is engaged, or proposes to engage, primarily in the business of investing, reinvesting, or trading in securities. The definition of "issuer" includes any organized group of persons, whether or not incorporated, that issues or proposes to issue a security.[34] The legislative history of the Investment Company Act also explains that an investment

company can consist of a group of individual investors that "is not a legal entity but rather ... in essence a combination of distinct individual entities."[35] Thus, an "organized group of persons" includes those client accounts, taken together, in investment management programs where the clients receive the same investment advice and hold the same or substantially the same securities in their accounts.[36] The law is clear that an investment vehicle does not have to involve pooling of assets in a single entity to be an issuer and hence an investment company: it need only involve an organized group of persons.

An investment company is formed from the separate accounts of investors who have purchased in separate accounts the same pre-packaged portfolio and rely upon the sponsor's portfolio updating service rather than significantly customize their portfolios (and thus hold the same or substantially the same securities). In essence, the investors who hold these accounts are an organized group of persons through their common reliance upon an ongoing program of parallel investment management and a connected share trading service. Such a group clearly is engaged primarily in the business of investing, reinvesting, or trading in securities. The investment companies thus formed should be subject to regulation under the 1940 Act unless they qualify for an exemption.

These investment companies cannot validly claim exemption from the 1940 Act based upon any precedent set by the *HOLDRs* no-action letter.[37] In that letter, the staff granted no-action relief to Merrill Lynch's HOLDRs program from registration under the 1940 Act (but not the 1933 Act). The letter relied on the fact that HOLDRs are only a custody arrangement allowing investors convenient way to purchase, hold, and sell fixed baskets of stocks representing a given industry or sector. Merrill Lynch only performs ministerial services for minimal administrative charges, selecting the stock through a mechanical process. Moreover, because HOLDRs round lots are exchange-traded, investors can sell their holdings for round lot value at any time without relying on Merrill Lynch.

In contrast, portfolio investment programs provide investors an ongoing program of investment

management. The pre-packaged portfolios do not remain fixed but rather are changed periodically, and with a click of the mouse investors can readily incorporate these changes into their portfolios, relying on the sponsor-arranged trading service to purchase, update, and liquidate their portfolios of odd lots and fractional shares at close to market value for round lots. Unlike the case of HOLDRs, the promoters of these investment programs charge more than a minimal administrative fee for providing this panoply of investment services.

Portfolio investment programs also do not qualify for the Rule 3a-4 "mini-account" exemption. Rule 3a-4 provides a non-exclusive safe harbor from the definition of investment company and from 1933 Act registration for programs under which investment advisory services are provided on a discretionary basis to a large number of advisory clients having relatively small amounts to invest. The conditions to the safe harbor are designed to ensure that clients in a program relying on the rule receive a particular sort of individualized treatment, including receiving sufficient personal attention from the adviser to their financial situations and investment objectives. Portfolio investment programs do not provide sufficient individualized attention to investors to meet the conditions or the policy objectives of Rule 3a-4. Rule 3a-4 contemplates that a program would provide the opportunity for personalized interaction rather than an impersonal or automated system. For instance, one condition requires that personnel who are knowledgeable about the account and its management be reasonably available to the client. The rule also contemplates that a qualifying program would actively reach out to clients for updates about their financial situations and investment objectives. Features of portfolio investment programs such as pre-packaged portfolios and non-personalized portfolio updating are inconsistent with these principles.

3. Compelling policy reasons warrant regulation of portfolio investment programs under the 1940 Act.

There are compelling policy reasons to require that portfolio investment programs register and be regulated under the 1940 Act. For the same reasons, regulation of these programs' sponsors

only as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act") or as broker-dealers under the Securities Exchange Act of 1934 (the "1934 Act") would not adequately address the potential for abuse that these investment companies pose.

First, pre-packaged portfolios present the possibility for self-dealing of the type that the 1940 Act was designed to prevent. For example, absent 1940 Act regulation, broker-dealers sponsoring portfolio investment programs could use pre-packaged portfolios as "dumping grounds" for securities inventory from unsuccessful underwritings or proprietary trading programs. Alternatively, a sponsor could add a security that it was underwriting or in which it made a market to a pre-packaged portfolio in order to develop trading volume and investor interest in that security. Disclosure of the resulting conflict of interest, even if made, would be obscured because each such security would be only one of many bundled and sold as a package. Congress, in enacting the 1940 Act, found that regulation under the 1934 Act and the Advisers Act was not sufficient to protect investors from such practices. Congress intended Sections 17 and 10(f) and the other anti-self-dealing provisions of the 1940 Act to combat these and similar abuses through a stronger, prophylactic remedy — prohibiting those transactions that posed special dangers.

The 1940 Act also regulates advisory and distribution charges. The current fee of $295 charged by FOLIOfn, for example, would be 295 basis points of a $10,000 investment. This fee is higher than most mutual fund expense ratios. Furthermore, absent 1940 Act regulation, there would be no constraints on raising the annual fee significantly or limiting the services provided for the fee in the future. For the reasons noted above, investors in portfolio investment programs who are dependent on a sponsor's professional investment management skills and on its trading service for odd lots and fractional shares have limited economic alternatives in the event of any future fee increases. Section 15 of the 1940 Act addresses this concern by requiring approval of any fee increase by a fund's board (including a majority of independent directors) and by shareholders. In addition, Section 36(b) imposes a fiduciary duty on investment advisers to

investment companies and their affiliates with respect to the compensation they receive. Neither the 1934 Act, nor the Advisers Act, nor the rules of the National Association of Securities Dealers, Inc. (the "NASD") impose similar standards.

Section 8(b) of the 1940 Act requires investment managers to manage their portfolios within the bounds of the portfolios' stated investment policies. Without appropriate oversight and regulation, the managers of pre-packaged portfolios could deviate at will from these policies, whether from a lack of discipline or in an attempt to pump up performance. Since investors in on-line investment companies rely upon pre-packaged portfolios to provide an ongoing program of investment management, they need the protections of the 1940 Act to enforce the stated investment objectives and policies of the pre-packaged portfolios. Neither the 1934 Act, nor the Advisers Act, nor NASD rules provide these investor protections.

Each of the conflicts of interest or other potential abuses described above is inherent in the structure of investment companies, including portfolio investment programs. Experience has shown that these conflicts are difficult to detect and police. The 1940 Act, unlike the 1934 Act or the Advisers Act, requires investment companies to adopt a corporate governance structure that is designed to meet this difficulty: it requires them to have a board of directors, at least forty percent of whom are disinterested and who are bound by fiduciary duties to represent the interests of investors.[38] This board of directors oversees and monitors the operations of the investment company to resolve conflicts in the interests of shareholders.

Investors in pre-packaged portfolios also need the protection of the advertising restrictions that apply to mutual funds. Absent those restrictions, a promoter might create a pre-packaged portfolio that had unrealistically high back-tested investment performance and then tout that performance to investors. A promoter also might advertise the performance of a pre-packaged portfolio in a manner inconsistent with the requirements of Form N-1A and the investment company advertising regulations under the 1933 Act. These provisions are designed to prevent abuses in and to standardize these types of communications with investors. SEC review of

prospectuses and NASD staff review of advertising serve as necessary checks on abuses in performance advertising. In contrast, the 1934 Act and NASD rules governing broker-dealer advertising establish a much weaker regime: they do not require prior or contemporaneous staff review of advertising and do not set specific standards for performance advertising.[39] While the Advisers Act does regulate performance advertising, its restrictions are not as rigorous, and it does not provide for prior or contemporaneous staff review.[40]

Regulation and registration under the 1940 Act would not impose unreasonable burdens on portfolio investment programs. Although they are not identical to traditional investment companies in all respects, other far more novel investment vehicles — particularly variable insurance products — have adapted to the regulatory pattern, and so could these investment companies. The requirements of the 1940 Act might be altered through exemptions tailored for operations and consistent with the investor protections ensured by the Act. The burdens of compliance with the 1940 Act are borne by the rest of the investment company industry, and a requirement that these investment companies also bear these burdens is essential to prevent erosion of the statutory protections for investors who rely on professional management.

Description of Proposed Rule

The proposed rule is designed to extend the regulatory protections of the 1940 Act to public investors who are offered the opportunity to participate in a common enterprise through pre-packaged portfolios and a sponsor's portfolio updating and trading features. It would treat all investors in such a program who purchase substantially the same portfolios coupled with portfolio updating and a connected trading service for portfolio securities as an investment company subject to the 1940 Act. The rule has three prongs, each designed to capture an element of these programs that renders them investment companies. To be defined as an investment company under the rule, a program would have to meet the conditions of all three prongs.

The first prong would include any program that offers a pre-selected portfolio of securities

reflecting a model portfolio selected pursuant to the program according to stated investment objectives, policies, or criteria. This prong is intended to encompass programs that offer common or parallel investment management on which investors are likely to rely and that investors can purchase in a single transaction or a comparably simple series of transactions.

The second prong would limit the scope of the rule to any program that periodically reviews the model portfolio to determine whether it needs to be changed to satisfy a stated investment objective or strategy and (1) adds and/or subtracts securities from the model portfolio or (2) changes the relative weighting of securities within the model portfolio. Taken with the first prong, this prong is intended to limit the rule to those programs that provide ongoing and updated common investment management.

The third prong would limit the scope of the rule to any program that provides or arranges for a service through which investors may execute the transactions in securities necessary to purchase the pre-selected portfolios specified in the first prong of the rule and to incorporate into their portfolios the periodic changes in the model portfolio specified in the second prong of the rule. This prong is intended to limit the rule to those programs that offer a trading service upon which investors will likely rely in order to realize their purchases of pre-packaged portfolios and periodic updates, such as a trading service for odd lots and fractional shares.

The rule is intended to clarify the scope of the definition of "investment company" under the 1940 Act and is not intended as an exclusive definition. Thus, an investment program that did not meet all of the conditions of the rule might still, under some circumstances, qualify under the 1940 Act as an investment company.

Conclusion

The sponsors of portfolio investment programs are offering to public investors professional investment management of a common securities portfolio — the touchstone of investment company regulation. Investors who purchase substantially the same pre-packaged portfolios, coupled with portfolio updating features and a connected share trading service, are an

organized group of persons engaged in a common investment enterprise, an enterprise that constitutes an investment company subject to the 1940 Act. Moreover, portfolio investment programs pose the same risks to investors that underlie important parts of the investment company regulatory pattern — risks of self-dealing, overreaching in fees, deviating from stated investment policies, inadequate mechanisms for resolving conflicts of interest, and abuses in disclosure and advertising.

There are compelling arguments for the Commission to act quickly to assert jurisdiction over portfolio investment programs under both the 1933 and 1940 Acts. There is no assurance that new sponsors of these investment companies will have the same level of integrity as current sponsors. These investment companies, if permitted to evade regulation, threaten to undermine the regulatory system for all investment companies. If these investment companies are not subject to regulation appropriate for the potential abuses they pose, their investors will be deprived of crucial protections. In addition, they will permit ready evasion of the burdens of investment company regulation. If the Commission acts quickly while the product is in an early stage, it can prevent regulatory evasion rather than face the task of trying to re-regulate a substantial sub-industry with a strong vested interest in fighting investor protections. Therefore, we respectfully request that the Commission adopt the definitional rule set forth in the Appendix clarifying that portfolio

investment programs are "investment companies" within the meaning of the 1940 Act.

Respectfully submitted,

Craig S. Tyle

General Counsel

Attachment

cc: Laura S. Unger, Acting Chairman

Isaac C. Hunt, Jr., Commissioner

Paul R. Carey, Commissioner

David M. Becker, General Counsel

Office of General Counsel

David B. H. Martin, Jr., Director

Division of Corporation Finance

Paul F. Roye, Director

Division of Investment Management

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,391 open-end investment companies ("mutual funds"), 489 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.2 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

[2] Currently, two sponsors — FOLIOfn Investments, Inc. and Netfolio, Inc. — are offering and selling interests in such portfolio investment programs. However, the number of sponsors will soon grow. See Matt Ackerman, *More 'Personal Portfolio' Internet Sites Coming,* American Banker (Dec. 13, 2000). A third sponsor — MAXFunds.com — is displaying its "synthetic funds" on its websites, although it is not yet offering shares in them for sale. According to press reports, E*TRADE Securities, Inc. and others also are considering offering portfolio investment programs. See Interview by Virginia Munger Kahn with Steven Wallman, Oct. 2000, *at* http://www.mfcafe.com/top/tb.html.; Joe Gose, *Do-It-Yourself*, Barron's Online, Jan. 8, 2001, *at* http://interactive.wsj.com/archive/retrieve.cgi?id=SB978756254620068368.djm.

[3] Investors generally retain most indicia of ownership of the individual stocks in their portfolios. They receive dividends and distributions and retain corporate voting rights.

[4] For instance, FOLIOfn categorizes its "Ready-to-go Folios" into types, each focused on a particular type of investment strategy. Some of the types (and some representative examples) are: investment style portfolios (e.g., Large-Cap Growth), risk-tailored portfolios (e.g.,

Aggressive, Conservative, or Market), Wall Street Analysts Folios (e.g., Analysts Choice), sector portfolios (e.g., the Technology Folio), major market portfolios (e.g., the Folio 30, based on the Dow Jones Industrial Average), geographic portfolios (i.e., region- and country-based), social issues portfolios (e.g., the Women Leaders Folio and the Environmentally Responsible Folio), and miscellaneous portfolios (e.g., the Dogs of the Dow Folio and the Stockcar Champs Folio).

[5] For instance, MAXFunds shows the three-month, one-year, and three-year performance results for each of its "synthetic portfolios." FOLIOfn's website displays three-month, six-month, one-year, three-year, and five-year performance results for each of its "Ready-to-go Folios." The visitor to the Netfolio website will be able to view, backtest, and compare the investment performance of each of its pre-packaged portfolios, which it calls "Personal Funds."

[6] FOLIOfn's website states:

At FOLIO*fn*, we select stocks for our Folios based on objective criteria, such as beta, market capitalization, price-to-book ratios, industry sectors and other objective measures. We believe this approach is consistent with the overwhelming number of studies that reveal the value of diversification and the difficulty of evaluating the merits of individual companies and selecting winning stocks.

[7] For instance, Netfolio, in describing its "Personal Funds," proclaims on its website:

Your Personal Fund's stocks are selected using quantitative investment strategies. These strategies look for stocks that meet specific measurable data, such as price-to-sales and shareholder yield. ... We test the performance of our investment strategies using COMPUSTAT, Standard & Poor's most comprehensive database. This test shows us how a given strategy might perform over similar economic and market conditions. We also use COMPUSTAT to select stocks for each Personal Fund.

[8] Although the MAXFunds sit does not yet offer its customers the direct ability to purchase shares in "synthetic funds," the chief executive officer of MAXFunds has stated that the company intends to do so through a "seamless" function offered in conjunction with a number of

on-line brokerage firms. David Hoffman, *Synthetic Funds Draw Scrutiny from Regulators*, Crain's Detroit Business, Nov. 13, 2000, at 22.

[9] See Hoffman, n.8 above. FOLIOfn is now offering a series of "Wall Street Analysts" pre-packaged portfolios, updated monthly, that reflect the recommendations of professional stock analysts. Netfolio is also proposing to offer virtual versions of the mutual funds offered by well-known traditional fund sponsors. Investors would pay a percentage of invested assets and would receive from the mutual funds' portfolio managers email notification of changes to the funds' portfolios. See Karen Damato, *Personal Funds May Challenge Industry*, Wall Street Journal, Oct. 6, 2000, at C1.

[10] Consider a portfolio worth $50,000 with 50 stocks equally weighted. Each holding will be worth $1,000. If a stock is bought at $30, the holding will consist of 33-1/3 shares. If the stock is bought at $80 a share, the holding will consist of 12-1/2 shares.

[11] As FOLIOfn states on its website: "[y]ou usually can't invest by dollar amounts because most brokers won't allow you to buy fractional shares of stock."

[12] One of FOLIOfn's financial backers has stated that "the proprietary trade-matching and -processing system is the key. Once FOLIOfn builds a base of thousands of customers ... its technology-based system could become very profitable." Patrick McGeehan, *The Unmutual Fund*, New York Times, May 18, 2000, at C1.

[13] The London-based manager of one of MAXFunds' portfolios has stated that it is "based on" one of his firm's offshore funds that could not be sold in the U.S., presumably because of the proscriptions of 1940 Act Section 7(d), which indicates their intent to avoid investment company regulation. David Hoffman, *Synthetic Funds Draw Scrutiny from Regulators*, Crain's Detroit Business, Nov. 13, 2000, at 22. MAXFunds' website also states that "synthetic funds" avoid "certain costs related to the structure of a mutual fund, like printing, accounting and *regulatory compliance costs*." (emphasis added)

[14] SEC v. W.J. Howey, Co., 328 U.S. 293, 298-299 (1946).

[15] SEC v. Glenn W. Turner Enter., Inc., 474 F. 2d 476, 482 n.7 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973).

[16] See Union Home Loans, Sec. Ex. Act Rel. 19,346, 26 SEC Dock. 1346, 1348 (1982). See also Loss and Seligman, Securities Regulation, vol. II 996.

[17] Investors generally face great difficulties in transferring brokerage accounts made up of odd lots and fractional shares, and liquidating one's holdings would incur trading costs and realize taxable capital gains.

[18] SEC v. Glenn W. Turner Enter., Inc., 474 F.2d at 482.

[19] While the Supreme Court expressly reserved judgment on whether the term "solely" should be interpreted literally, it deleted the term in its restated formulation of the test: "The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 n.16 (1975).

[20] Commission's Statement to Builders and Sellers of Condominiums of their Obligations under the Securities Act, Sec. Act Rel. 5347 (Jan. 18, 1973).

[21] Hocking v. Dubois, 885 F.2d 1449, 1460 (9th Cir. *en banc,* 1989), *cert. denied*, 494 U.S. 78 (1990) (the purchaser of a condominium who is offered the option to participate in a rental pool arrangement or to manage his investment himself has purchased an investment contract even given the purchaser's election to delegate control and ability to regain control).

[22] 328 U.S. at 301.

[23] Id. The *Howey* Court thus found that its conclusions were "unaffected by the fact that some purchasers [chose] not to accept the full offer of an investment contract by declining to enter into a service contract with the respondents."

[24] The *Howey* Court noted that the orange grove parcels in question were offered to "persons who reside in distant localities and who lack the [necessary] equipment and experience ... ." 328 U.S. at 300. In SEC v. Aqua-Sonic Products Corp., Judge Friendly found that a dental

product franchise was a security where the offerings of franchises were "aimed primarily at investors who could not reasonably be believed to be desirous and capable of undertaking [dental product] distribution on their own." 687 F.2d 577, 583 (2d Cir. 1982).

[25] For instance, Netfolio's home page proclaims:

GOODBYE MUTUAL FUNDS

HELLO NETFOLIO

[26] SEC v. Continental Commodities Corporation, 497 F.2d 516 (1974). See also Popham, Haik, Schnobrich, Kaufman & Doty v. Newcomb Securities Company, 751 F.2d 1262, 1265 (1985). The *Popham* court stated: "Even if the plan required all investors to direct their funds, moreover, the Fifth Circuit, at least, would treat the plan as an investment contract if the investors could be expected in practice to rely on the promoter's advice." But see Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216 (6th Cir. 1980).

[27] Hocking v. Dubois, above n.21.

[28] SEC v. Aqua-Sonic Products Corp., 687 F.2d at 582-584, above n. 24. Judge Friendly held that "[it] has long been understood that mere existence of such an option [to direct one's investment] is not inconsistent with the entire scheme's being an investment contract."

[29] SEC v. Brigadoon Scotch Distributors, Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975). The court noted that "[t]he fact that selection by [the dealer's] experts was at the option of the buyer is irrelevant because it is the *offer*, not the acceptance of the offer, that controls." (emphasis in original)

[30] Hocking v. Dubois, above n.21.

[31] Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith., Inc., 756 F.2d 230 (2d Cir. 1985). The court stated:

Here investors are buying something more than individual certificates of deposit. They are buying an opportunity to participate in the CD Program and its secondary market. And, they are paying for the security of knowing that they may liquidate at a moment's notice free from

concern as to loss of income or capital, while awaiting for FDIC or FSLIC insurance proceeds.

[32] One might argue that the offerings of portfolio investment programs do not form investment contracts under the holding of SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996). This case, however, is not on point. The *Life Partners* court distinguished between services provided by a promoter before an investor purchased the product and those provided after the purchase. The court noted that the defendants prior to the purchase served as finders and promoters and after the purchase merely provided ministerial services, and held that these services did not suffice to meet the "efforts of others" element of the *Howey* test. In clear contrast, the sponsors of portfolio investment programs provide pre- and post-purchase an ongoing program of investment management, and post-purchase provide an odd lot and fractional share trading service. Both of these services are entrepreneurial and not ministerial.

[33] Thus, the sponsors of portfolio investment programs could rely upon SEC guidelines stating that the prospectus delivery requirements have been met when (1) an investor is provided sufficient notice of the posting, (2) the investor has sufficient access to the posting, and (3) there is sufficient evidence of delivery of the prospectus to the investor. See Use of Electronic Media for Delivery Purposes, Release Nos. 33-7233, 34-36345, IC-21399 (Oct. 6, 1995). These guidelines state that the evidence of delivery requirement can be met through an investor's informed consent or through the investor's accessing supplemental sales literature where the supplemental sales literature and the prospectus are both posted for open access on the website.

[34] 1940 Act Section 2(a)(22) defines "issuer" to include any person who issues any security. Under Section 2(a)(28), a "person" includes a company, and under Section 2(a)(8) a "company" includes any organized group of persons, whether incorporated or not.

[35] H.R. Doc. No. 707, 75th Cong., 3rd Sess. 24 (1939). One court, citing this legislative history, found that "organized group of persons" does not refer only to identifiable business entities. Prudential Insurance Co. of America v. SEC, 326 F. 2d 383 (3rd Cir.), *cert. denied*, 377 U.S. 953

(1964) (separate account in which insurance company proposed to invest premiums of variable insurance contracts is an investment company because the purchasers of the contracts are an "organized group of persons"). See also Bancroft Convertible Fund, Inc. v. Zico Investment Holdings Inc., 825 F.2d 731, 737 (3d Cir. 1987).

[36] The SEC first articulated this position in an enforcement action against a discretionary investment program and has reiterated it in the proposing release for Rule 3a-4 under the 1940 Act, which governs such programs. See SEC v. First National City Bank, Litigation Release No. 4534 [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) 92592 (Feb. 6, 1970); Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 21260 (July 27, 1995).

[37] Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC No-Action Letter (pub. avail. Sept. 3, 1999).

[38] The Commission has recently adopted amendments to certain key exemptive rules under the 1940 Act to require that, for investment companies that rely on those rules: (1) disinterested directors constitute at least a majority of their board of directors; (2) disinterested directors select and nominate other disinterested directors; and (3) any legal counsel for the disinterested directors be independent. Role of Independent Directors of Investment Companies, Release Nos. 33-7932, 34-43786, IC-24816 (Jan. 2, 2001).

[39] See NASD Conduct Rule 2210. This rule only mandates review of a member's advertising by a registered firm principal, sets recordkeeping requirements for advertisements, and provides for spot reviews by the NASD staff of these records.

[40] See Rule 206(4)-1 under the Advisers Act; Clover Capital Management, Inc., SEC No-Action Letter (pub. avail. Oct. 28, 1986). Enforcement of these standards generally falls to review by the SEC staff during periodic examinations or to ex post facto SEC enforcement action.

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